IT 99-20
Tax Type: Income Tax
Issue: Unitary – Inclusion of Company(ies) in a Unitary Group
Holding Companies

STATE OF ILLINOIS
DEPAPTMENT OF REVENUE
OFFICE OF ADMINSITRATIVE HERINGS
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS

No. 95-IT-0000
FEIN: 00-0000000

"ALDRITCH CASUALTY CO.",

Taxpayer

RECOMMENDATION FOR DISPOSITION

Appearances: Mr. Alan Lindquist of Winston & Strawn and Mr. David Hathaway of Beckman, Weil, Sheparson & Faller, LLC for "Aldritch Casualty Co"; Ms. Kathryn Michaelis, Special Assistant Attorney General for the Illinois Department of Revenue.

Synopsis:

At issue in this case is whether the Illinois Department of Revenue ("Department") correctly included "Aldritch Financial Corporation" in a unitary business group with its first and second-tier insurance subsidiaries. During 1991 through 1994, (the "relevant years"), the corporate structure included "Aldritch Financial Corporation" ("AFC"), a publicly traded corporation with its sole place of business in "Someplace", Ohio. Stip. ¶ 2. "AFC" wholly-owned two subsidiaries: (1) "AFC Investment

Company" ("AFC-I"), a corporation that managed corporate real estate, provided leasing and financing services, and managed corporate consolidated purchasing authority for "AFC" and "AFC's" subsidiaries; and (2) "Aldritch Insurance Company" ("AIC"), a property and casualty insurance company. Stip. ¶¶ 23 and 28. "AIC" wholly owned three insurance company subsidiaries: (1) "Aldritch Casualty Company" ("ACC"), a property and casualty insurance company; (2) "Aldritch Indemnity Company ("AID") a property and casualty insurance company and (3) "Aldritch Life Insurance Company" ("ALIC"), a life insurance company. Stip. ¶¶ 32, 37 and 42. During the relevant years, "AIC", "AID", "ACC", "ALIC" filed Illinois corporate income tax returns, Form IL-1120, on a separate company basis. Stip. ¶¶ 28, 33, 38, 43.

Upon audit, the Department determined that "AFC" was a holding company and conducted a unitary business with its first and second-tier insurance subsidiaries ("AIC", "AID", "ACC", and "ALIC") and its leasing company subsidiary ("AFC-I") for the years 1991 through 1994. Stip. ¶ 122 and Ex. 49. Pursuant to Section 1501(a)(27), which provides that companies with differing apportionment formulas cannot be included in the same unitary group, "AFC's" income was allocated between the insurance companies' group and the leasing company based upon gross receipts. See, Stip. ¶ 122, Schedule I-b of Exhibit 49 and Schedule I-1 of Exhibit 62. Notices of Deficiency and Notices of Overassessment were issued to "AIC", "AID", "ACC", and "ALIC" (collectively "taxpayer"). Stip. Ex. Nos. 28-35.

Taxpayer timely protested the NOD's and filed protective claims for the Notices of Over-assessment. In its protest, taxpayer contended that "AFC" is not a holding company, thus, it may not be part of a unitary business group with its insurance

subsidiaries, which utilize a one-factor apportionment formula. Taxpayer has also requested alternative apportionment under Section 304(f) of the Illinois Income Tax Act ("IITA") and an abatement of Section 1005 penalties due to reasonable cause.

In the instant matter, the parties have filed a Joint Stipulation of Facts and memoranda of law in support of their respective positions. Following a review of the record and briefs filed herein, it is recommended that the Notices of Deficiency be finalized as revised by the Department auditor's amended audit figures. (*See*, Schedule I-b of Stip. Ex. No. 49 and Schedules I-1 and I of Stip. Ex. 62.)[1]

Facts Not in Dispute & Findings of Fact:

1. For the years 1991, 1992, 1993, and 1994 (the "relevant years"), the corporate structure consists of a parent company, "Aldritch Financial Corporation" ("AFC"), and two wholly owned subsidiaries, "Aldritch Insurance Company" ("AIC") and "AFC-Investment Company" ("AFC-I"). "AIC" has three wholly owned insurance subsidiaries: "Aldritch Casualty Company" ("ACC"), "Aldritch Life Insurance Company" ("ALIC") and "Aldritch Indemnity Company" ("AID"). Stip. ¶ 1.
2. "AFC" was a Delaware corporation from January 1, 1991 through March 3, 1992 and an Ohio corporation from March 4, 1992 through December 31, 1994. "AFC" is a publicly traded corporation with its principal and sole place of business [in] "Someplace", Ohio. Stip. ¶ 2.
3. During the relevant years, "AFC", "AFC-I", "ACC", "AIC", "AID", and "ALIC" were headquartered in the same building in "Someplace", Ohio. Stip. ¶ 118.
4. "AIC", "AID", "ACC" and "ALIC" are insurers or insurance companies. Stip. ¶ 74.

5. Neither "AFC" nor "AFC-I" are insurers or insurance companies. Stip. ¶ 75.

6. For the relevant years, "AFC's" Board of Directors appointed an Executive Committee, an Audit Committee, a Compensation Committee, a Nominating Committee, and an Investment Committee. Stip. ¶ 7.

7. For the relevant years, the "AFC" Board of Directors, its Executive Committee, its Audit Committee, its Nominating Committee, its Investment Committee, and its Compensation Committee were made up of various directors of "AFC" as well as officers thereof. Stip. ¶ 9; Stip. Ex. Nos. 1-4, inside back page.

8. For the relevant years, the Executive Committee of "AFC" met at least four times a year and reviewed, among other things, the equity portfolio of "AFC" and the real estate and leasing of "AFC"-1. Stip. Ex. No. 10; Stip. ¶ 17.

9. For the relevant years, the Investment Committee was comprised of the same individuals for all companies – "AFC", "Aldritch Insurance Companies", "Aldritch Indemnity Co.", "Aldritch Casualty Co.", "Aldritch Life Insurance Co." The Investment Committee would meet and consider each company's investments separately and generate separate minutes for each company's investment committee meetings, even though these meetings would occur on the same day, at the same place, one after the other. Stip. ¶ 18; Stip. Ex. Nos. 5-8; Stip. Ex. No. 13, pp. 20, 21, lines 13, 15.

10. For the relevant years, as stated in "AFC's" Annual Reports, "AFC-I" functioned as a management company for corporately owned real estate, including the "AFC" Headquarters and three investment buildings with high occupancy rates. "AFC-I"

[1] Taxpayer's protective claims are granted to the extent that they correspond to the Department's Notices of

also supported the insurance groups' independent agencies by leasing and financing vehicles and equipment to them and their clients. "AFC-I" also managed consolidated corporate purchasing authority for the parent and all five subsidiaries. Stip. ¶ 23; Stip. Ex. Nos. 1, p. 13; 2, p. 12; 3, p. 12; 4, p. 11; 19, pp. 2-4.

11. "AIC" is a property and casualty insurance company which conducted business in Illinois and filed an Illinois corporate income tax return, Form IL-1120, on a separate company basis for the relevant years. Stip. ¶ 28.
12. For the relevant years, "AIC" had its own shareholders' meeting and Board of Directors ("Robert S. Frost"; "Daniel W. Defoe"; "Percy B. Shelly"; "Percy B. Shelly, Jr."; "Edgar A. Poe"; "William B. Yeats"; "Alan W. Shelly"; "Peter F. Shelly"; "Leon W. Uris"; and "Alfred M. Hitchcock", all of whom are also directors of "AFC"; and ""Michael C. Crichton"). Stip. ¶ 29; Stip. Ex. Nos. 1, 2, 3, 4 (inside of the back page).
13. "AID" was incorporated in Ohio and conducted business in Illinois as an insurance company. Stip. ¶ 32.
14. "AID" filed Illinois corporate income tax return, Form IL-1120, on a separate company basis for the relevant years. Stip. ¶ 33.
15. For the relevant years, almost all of the "AID" Board of Directors were also members of the "AIC" Board of Directors. Stip. ¶ 35.
16. For the relevant years, "AID" had its own officers. Stip. Ex. Nos. 1,2,3,4.
17. "ACC" was an Ohio corporation which conducted business in Illinois as an insurance company. Stip. ¶ 37.

Over-assessment. *See*, Stip. Ex. Nos. 31, 31, 35.

18. “ACC” filed Illinois corporate income tax return, Form IL-1120, on a separate company basis for the relevant years. Stip. ¶ 38.

19. For the relevant years, “ACC” had its own Board of Directors comprised of “Robert S. Frost”; “Daniel W. Defoe”; “Percy B. Shelly”; “Percy B. Shelly, Jr.”; “Edgar A. Poe”; “Alan W. Shelly”; “Peter F. Shelly”, who were directors of “AFC”; and “”Steven B. King”; “Alfred P. Lunt”; “Michael C. Crichton”, and “David W. Dukes”, who were not directors of “AFC”. Stip. ¶ 40; Stip. Ex. Nos. 1, 2, 3, 4, (see inside back page).

20. “AIC” and its two subsidiaries, “AID” and “ACC”, formed the property and casualty insurance group of “AFC”. Stip. ¶ 41.

21. “ALIC” was incorporated in Ohio and conducted business in Illinois as an insurance company. Stip. ¶ 42.

22. “ALIC” filed an Illinois corporate income tax return, Form 1120, on a separate company basis for the relevant years. Stip. ¶ 43.

23. Together “AIC”, “AID”, “ACC” and “ALIC” formed the insurance group of “AFC”. Stip. ¶ 45.

24. For the relevant years, “ALIC” had its own directors: “Robert S. Frost”; “Daniel W. Defoe”; “Percy B. Shelly”; “Percy B. Shelly, Jr.”; “Edgar A. Poe”; “William B. Yeats”; “Alan W. Shelly”, “Peter F. Shelly”, and “”Nancy A. Drew, all of whom were directors of “AFC”; and ”Courtney R. Love”; “Michael C. Crichton”; and “Penelope T. Baker”, who were not directors of “AFC”. Stip. ¶ 46; Stip. Ex. Nos. 1, 2, 3, 4, (see inside back page)

25. The protested issues that remain the subject of this Administrative Hearing are the following:

    a. Whether "AFC" constitutes a holding company as that term is used in Section 1501(a)(27) of the Illinois Income Tax Act (35 ILCS 5/1501(a)(27)?

    b. Whether taxpayer is entitled to alternative apportionment due to gross distortion pursuant to Section 304(f) of the Illinois Income Tax Act (35 ILCS 5/304(f)?

    c. Whether penalties should be imposed pursuant to Section 1005 of the Illinois Income Tax Act (35 ILCS 5/1005)?

    Stip. ¶ 55.

26. During the relevant years, state regulatory restrictions on investments for insurance companies prevented "AFC's" insurance subsidiaries from investing any more than 10% of their prior year's assets in equities such as common stocks. Stip. ¶ 60; Stip. Ex. No. 13, p. 22, lines 1-8.

27. "AFC's" strategy in non-subsidiary equity investments was to identify approximately 10 to 12 companies in which it could accumulate 10% to 20% of their common stock. Stip. ¶ 63; Stip. Ex. No. 19, p. 3.

28. As of December 31, 1991, "AFC" had unrelated (non-subsidiary equity investments of $717,507,000 and debt investments of $39,513,000 (rounded to the nearest one thousand dollar). Stip. ¶ 65; Stip. Ex. No. 19, pp. 13-14; Stip. Ex. No. 23, lines 14-15.

29. As of December 31, 1992, "AFC" had unrelated (non-subsidiary) equity investments of $886,653,000 and debt investments of $94,260,000. Stip. ¶ 66; Stip. Ex. No. 23, lines 14-15.

30. As of December 31, 1993, "AFC" had unrelated (non-subsidiary) equity investments of $964,071,000 and debt investments of $156,206,000. Stip. ¶ 67; Stip. Ex. No. 23, lines 14-15.

31. As of December 31, 1994, "AFC" had unrelated (non-subsidiary) equity investments of $945,688,000 and debt investments of $208,698,000. Stip. ¶ 68; Stip. Ex. No. 23, lines 14-15.

32. "AFC" had income from unrelated (non-subsidiary) investments of $26,637,607 in 1991, $31,882,162 in 1992, $38,678,969 in 1993, and $50,276,566 in 1994. Stip. ¶ 69; Stip. Ex. No. 23, line 2.

33. "AFC" incurred expenses in conducting its activities totaling $9,035,449 in 1991; $8,636,600 in 1992; $10,031,986 in 1993; and $13,056,296 in 1994. Stip. ¶ 70; Stip. Ex. No. 23.

34. "AFC" was formed to own 100% of the stock of "AIC" and to own 100% of the stock of "AFC" Investment Company. Stip. ¶ 71; Stip. Ex. No. 9, p. 7.

35. "AFC's" equity in the net assets of subsidiaries totaled $874,078,168 in 1991, $1,109,459,016 in 1992, $1,202,033,663 in 1993, and $1,196,939,617 in 1994. Stip. ¶ 72; Stip. Ex. No. 23.

36. More than 60-75% of "AFC's" dividends came from its subsidiaries. Stip. ¶ 94; Stip. Ex. No. 16, p. 74, Stip. Ex. No. 23.

37. The dividends paid by the subsidiaries to "AFC" as a parent were determined by the boards of the subsidiaries. Many of the subsidiaries' directors were also directors of "AFC". Stip. ¶ 95; Stip. Ex. No. 9, p. 42; Stip. ¶¶ 29, 35, 40, 46.

38. "AFC" characterized itself as a holding company in its own annual reports. Stip. ¶ 108; Stip. Ex. No. 16, p. 85, line 19; p. 86, line 15; Stip. Ex. Nos. 1,2,3, and 4; Stip. Ex. No. 18.

39. During the relevant years, "AFC" characterized itself as a holding company in its Form 10-K statements. Stip. Ex. Nos. 19-22; Stip. ¶ 110.

40. Amendments to the Insurance Holding Company System Registration Statement with the Insurance Department of Ohio were filed in which "AFC" stated that its "[p]rincipal business is that of a holding company." Stip. Ex. No. 54.

41. Taxpayer admitted that "AFC" was a holding company in its initial protest letter dated September 7, 1995, filed in response to the Department's Notices of Deficiency. In this initial protest it maintained that "AFC" was not unitary with its first and second-tier insurance subsidiaries. Stip. Ex. No. 36, p. 3.

42. Taxpayer filed an amended protest on July 10, 1998, wherein it stated that "AFC" was *not* a holding company, therefore, it could not be included in a unitary business group with its first and second-tier insurance subsidiaries. Stip. Ex. No. 39.

43. The funds that "AFC" used in purchasing unrelated securities came in part from dividends received from its subsidiaries, in part from its debt and equity public offerings and in part from its own income. Stip. ¶ 114.

44. Bank Account number 000-00000 at (Fictitious) Bank in "Anyplace", Ohio, was used by taxpayer for all of the following: deposits of dividends received by "AFC" from its subsidiaries ("AFC-I", "AIC", "ACC", "ALIC", and "AID"); deposits of dividend and capital gain income from stock owned in related companies; and a source of funds used to purchased securities of unrelated companies. Stip. ¶ 121.

45. “AFC-I” paid interest income to “AFC” in 1991 and 1992 for loans issued by “AFC” to “AFC-I”. ¶ 125.

46. “AFC”, “AIC”, “ALIC”, “ACC”, and “AID” each had their own Investment Committees consisting of the same individuals. For the relevant years, the individuals present at each company’s Investment Committee meetings consisted primarily of the following: “Percy B. Shelly”, “Daniel W. Defoe”, “Edgar A. Poe”, “Percy B. Shelly, Jr.”, “Robert S. Frost”, E. M. Hemmingway”, “Arthur M. Miller”, “Jack J. Miller”, “Michael C. Crichton”, “William B. Yeats”, “Jack London”, “Alfred M. Hitchcock”, “”Theodore S. White”, “Donald W. Trump”, and “Leon W. Uris”. Stip. ¶ 128.

47. Employees paid by “AIC” as the common paymaster performed numerous service functions for “AFC”, “AFC-I”, “ACC”, “AID”, and “ALIC”, including, but not limited to: accounting, payroll, audit, computer, legal, financial, and tax services. Stip. ¶ 115.

48. The following individuals were employed by “AIC” during all or a portion of the relevant years as stock transfer clerks for “AFC”: “”Bonnie Rait”, “Elizabeth Hurley”, “Linda Kozlowski”, and “Tina Turner”. Stip. ¶ 119.

49. In return for some of the services provided by “AIC” as identified in item Stip. ¶ 115, “AID” and “ACC” paid “AIC” a fee. Stip. ¶ 116.

50. During the relevant years, neither “AFC” nor “AFC-I” paid any fee to “AIC” for the services provided to it by “AIC”, as identified in Stip. ¶ 115. Stip. ¶ 117.

51. “AFC” never paid wages, and “AIC”, the common paymaster, did not cross-charge “AFC” for the wages paid. Stip. ¶ 124; Stip. Ex. Nos. 50-53, line 13.

52. "AFC" had no depreciable assets during the tax years as reflected on "AFC's" Condensed Financial Information of Registrant Parent Only, and the breakdown of the "Other Asset" line of Exhibit 23, as shown in Stip. ¶ 130. *See also*, Stip. Ex. 9, p. 28, lines 20-25; p. 29, lines 1-3 and Stip. Ex. No. 50-53, line 30.

53. "AFC" was initially capitalized by an exchange of stock from "AIC's" shareholders. Stip. Ex. No. 9, p. 8, lines 8-13.

54. After its initial capitalization, "AFC's" funding included: dividends from stock, interest on bonds, capital gains, dividends received from "AIC" and the issuance of convertible debentures. Stip. Ex. No. 9; p. 8 ("Theodore S. White's" testimony).

55. The percentage of "AFC's" dividend income that was derived from its subsidiaries was approximately: 70% in 1991, 55% in 1992, 77% in 1993, and 61% in 1994. Stip. Ex. No. 23, Condensed Financial Information of Registrant Parent Company Only, ("Dividends from subsidiaries" vs. "Total Income" lines); Stip. Ex. No. 13, p. 64, lines 12-20.

56. In 1992, "AFC" distributed the proceeds of a convertible debenture offering to "AIC". "AIC" then provided additional capital to "ACC". Stip. Ex. No. 13, pp. 23-24; and Stip. Ex. No. 59. This additional capital allowed the insurance companies to write more premiums since the Ohio and Illinois Insurance Departments require specific capitalization levels. Stip. Ex. No. 13, p. 60, lines 6-25.

57. The Department allocated "AFC's" income between the unitary business group of insurance companies and the non-unitary companies based upon gross receipts. Schedule I-b of Stip. Ex. No. 49 and Schedules I-1 and I of Stip. Ex. 62.

Conclusions of Law:

The first issue is whether "AFC" constitutes a holding company as that term is used in Section 1501(a)(27) of the Illinois Income Tax Act, 35 **ILCS** 5/101 *et seq*. On audit, the Department determined that "AFC" was a holding company that conducted a unitary business with its one-factor insurance companies ("AIC", "ACC", "ALIC", and "AID") and its three factor leasing company ("AFC-I"). Pursuant to Section 1501(a)(27) of the IITA, a unitary business group cannot include members that ordinarily apportion their income under different subsections of Section 304 of the IITA. 35 **ILCS** 5/1501(a)(27). However, for tax years ending on or after December 31, 1987, the prohibition on combining one-factor and three factors does not apply to:

> A unitary business group composed of one or more taxpayers all of which apportion business income pursuant to subsection (b) of Section 304, or all of which apportion business income pursuant to subsection (d) of Section 304, and a holding company of such single-factor taxpayers …

35 **ILCS** 5/1501(a)(27)

Since insurance companies apportion their business income pursuant to subsection (b) of Section 304 of the IITA, the Department is authorized to include a holding company in a unitary business group of insurance companies that apportion their business income pursuant to the one-factor formula of Section 304(b). *See*, 35 **ILCS** 5/304(b). During the audit, the Department allocated "AFC's" income between the unitary business group of insurance companies and "AFC-I", its leasing subsidiary based upon gross receipts. *See*, Schedule I-b of Stip. Ex. No. 49 and Schedules I-1 and I of Stip. Ex. Nos. 62.

The taxpayer does not dispute that "AFC" was engaged in a unitary business with its insurance subsidiaries and "AFC-I", its leasing subsidiary. (*See*, Stip. ¶ 55 & pre-hearing order). It only argues that the Department is precluded from including "AFC" in the unitary group with its insurance subsidiaries because "AFC" is not a holding company. *See*, 1501(a)(27); Stip. ¶ 55; pre-hearing order. Taxpayer maintains that "AFC" is an operating company because it did more than merely hold the stock of its subsidiaries, "AFC" engaged in business operations during the relevant years.

The Illinois Income Tax Act and the Department's regulations do not specifically define "holding company," taxpayer, therefore, proposes that the definition in Black's Law Dictionary should be adopted. Black's Law Dictionary defines holding company as follows:

> A company that confines its activities to owning stock in, and supervising management of, other companies. A holding company usually owns a controlling interest in (more than 50 percent of the voting stock) the companies whose stock it holds. A corporation that controls the voting power of other individual corporations for the purpose of united action.

Black's Law Dictionary 658 (5th ed. 1979).

The primary rule of statutory interpretation is to ascertain and give effect to the true legislative intent. Legislative intent should first be ascertained from the language used by the legislature, examining the statute as a whole and considering each part in connection with every other section. In interpreting statutory language the court should look to both the particular language at issue and the statute as a whole, thus, the term "holding company" must be read in context. Illinois Power Co. v. Mahin, 49 Ill. App. 3d 713 (1977). While the definition stated in Black's Law Dictionary may be useful in

determining what constitutes a holding company under the Act, it is obviously not determinative. Notably, this definition does not differentiate among holding companies for federal tax purposes, state tax purposes, insurance law, banking law, securities law and so forth.

Significantly, the taxpayer has failed to cite any case law which establishes that a holding company is confined to merely holding the stock of another corporation. In fact, the instructions to IL-1120, Schedule UB, which have the effect of a Departmental regulation pursuant to Section 1501(a)(19), indicate that a holding company may also be unitary in operations with one or more of its subsidiaries. Those instructions state in relevant part:

> "A holding company should generally be treated as unitary with one or more subsidiaries if:
> a. It is unitary in operations with one or more of the subsidiaries (in which event it would be an operating-holding company); or
> b. It holds, directly or indirectly, the capital stock of a subsidiary (or of more than one subsidiary which conducts unitary operations); or
> c. The filing by it of a separate return would distort the business income of the controlled group attributable to Illinois."

Schedule UB Instructions to 1992 IL-1120.[2]

One state Supreme Court has acknowledged that the term "holding company" is not a "term of art." Bassett v. Neeld, 130 A.2d 1, 5, 23 N.J. 551 (1957). The court noted that a "holding company" has included corporations organized and operated for the sole purpose of holding a controlling interest in the stock of one or more corporations. It has also included an ordinary operating company which quite incidentally owns stock in another corporation. Id. at 559.

[2] During the relevant years, 1991–1994, almost identical provisions existed in the IL-1120 Schedule UB instructions.

In support of its position that "AFC" is not a holding company, the taxpayer cites Shaklee v. Illinois Department of Revenue, Circuit Court of Cook County, Illinois, Docket No. 93-L-50530 (Sept. 25, 1996), *aff'd* Illinois Appellate Court, Docket No. 1-96-3780 (August 12, 1998) (unpublished), *appeal denied*, 181 Ill. 2d 588 (Dec. 2, 1998).[3] Taxpayer essentially compares "AFC" to Shaklee and concludes that since "AFC's" activities are not identical to Shaklee's, "AFC" cannot be deemed a holding company. In Shaklee, the court was addressing (1) whether two intermediary subsidiaries were unitary with their three-factor manufacturing parent, Shaklee; (2) whether the holding companies were financial organizations and (3) whether they conducted more than 80% of their business outside of the U.S. The taxpayer argues that the decision in Shaklee is relevant because in the absence of a statutory definition of holding company, the court adopted the definition set forth in Black's Law Dictionary. The court, however, was attempting to distinguish between a holding company and an investment company. In this same decision, the Judge rejects the taxpayer's proposal of adopting the definition of "investment company" as stated in Black's Law Dictionary because it leads to a result which is inconsistent with legislative intent, (Illinois State Tax Reporter (CCH) at 24,328), thus, underscoring the precariousness of simply adopting a definition stated in Black's Law Dictionary. The issue of what constitutes a holding company was simply not before the court, therefore, the court's analysis in Shaklee sheds little light on whether "AFC" constitutes a holding company under the IITA.

The taxpayer also cites Administrative Hearing Decision IT 98-9 to support its position. The only issue in IT 98-9, however, was whether gain from the sale of a

[3] Reported in Illinois State Tax Reporter at ¶400-797 and ¶400-952 (CCH), respectively.

holding company was business income or non-business income. Whether a specific company constituted a holding company was not at issue, therefore, the decision affords little insight in the present matter.

In determining whether "AFC" is a holding company as contemplated by IITA Section 1501(a)(27), an analysis of its business activities must be made. Taxpayer argues that "AFC" constituted an operating company since it was engaged in business operations throughout the audit period, namely, it alleges "AFC" actively managed a diverse portfolio of equity investments and directed the leasing operations of its subsidiary, "AFC-I". Taxpayer's Initial Brief, pp. 9-13.

Despite the taxpayer's contentions that "AFC's" direction of "AFC-I's" leasing operations preclude its characterization as a holding company, the evidence of record does not reveal that "AFC" engaged in any activities that are atypical of a parent holding company. It was "AFC-I" employees who wrote leases for insurance agents of "AIC" or the other affiliates and the customers of the insurance agencies. Stip. Ex. No. 13, p. 12, lines 7-18. "AFC-I" maintained records of the leases. Stip. Ex. No. 9, p. 11, lines 7-8. "AFC-I" collected the lease payments. Stip. Ex. No. 13, p. 13, lines 1-7. "AFC-I's" president could independently sign leases under $500,000. Stip. Ex. No. 14, lines 6-11; Stip. Ex. No. 13, p. 17, 18, lines 1-7. Customers who entered into leases dealt directly with "AFC-I" personnel or an insurance agent who would refer them to "AFC-I". Stip. Ex. No. 9, p. 19, lines 17-25; p. 20. "AFC-I" had approximately ten employees during the audit period that conducted these leasing operations. Stip. Ex. No. 13, p. 12, lines 1-4.

"AFC" employees did not perform leasing operations during the relevant years. The record reflects that the only individuals that may have participated in the leasing operations were officers or directors of "AFC", not employees of "AFC". Five of "AFC's" directors and/or officers: ""Robert S. Frost", "Daniel W. Defoe", "Percy B. Shelly", "Percy B. Shelly, Jr.", and "Edgar A. Poe" were also "AFC-I" directors and/or officers, thus obligating them to direct and control the leasing operations of "AFC-I" in their capacity as directors and/or officers for "AFC-I". Thus, it cannot be said that "AFC" was a leasing corporation, nor should its activities with respect to its leasing subsidiary preclude it from being characterized as a holding company.

Taxpayer also argues that it actively managed its investment portfolio, therefore, it is a distinct operating company not a holding company. "AFC", which owned 100% of the stock of "AIC" and 100% of the stock of "AFC-I", is publicly traded on the NASDAQ exchange. Its corporate charter states that "AFC" was organized " … to engage in any lawful act or activity or activity for which corporations may be organized under the Ohio general corporation law…" Stip. Ex. No. 17. Further, the taxpayer points out that "AFC" owned equity securities investments at a fair market value in 1991 of $717 million, 1992 of $886 million, 1993 of $964 million, and 1994 of $945 million. It owned well over $1 billion of equity and fixed-market securities as of December 31, 1994. Stip. Ex. No. 23, Condensed Balance Sheet, II. 2 and 3.

However, it is also important to consider that during the relevant years, "AFC" had only two to three employees, stock transfer clerks, who were devoted entirely to "AFC's" activities. Stip. ¶ 119. "AFC" never paid wages, and "AIC", the common paymaster, did not cross-charge "AFC" for the wages paid. Stip. ¶ 124; Stip. Ex. Nos.

50-53, line 13. "AFC" had no depreciable assets during the tax years as reflected on "AFC's" Condensed Financial Information of Registrant Parent Only, and the breakdown of the "Other Asset" line of Exhibit 23, as shown in Stip. ¶ 130. *See also*, Stip. Ex. 9, p. 28, lines 20-25; p. 29, lines 1-3 and Stip. Ex. No. 50-53, line 30. Finally, "AFC" did not have business customers or trade securities on behalf of other corporations.

Taxpayer alleges "AFC" actively managed its portfolio of stocks and bonds by the investment department which made decisions through the investment committee meetings. *See*, Stip. Ex. No. 9, p. 20, lines 13-25; p. 21, lines 1-6. The record, however, does not support this contention. The investment department only consisted of 5-7 employees, moreover, it served as the investment department for the insurance companies as well as "AFC". Stip. Ex. 9, p. 21-22, lines 7-17 and lines 5-9; and Stip. Ex. No. 9 p. 37, lines 20-24; Stip. Ex. 13, pp. 20-21. "AIC", not "AFC", incurred the salary/wage expense for these individuals. Stip. ¶¶ 115, 124. These individuals essentially provided investment guidance to the five unitary companies, thus, their activities should not preclude "AFC" from characterization as a holding company.

The source of "AFC's" dividend income is another important factor for consideration. "AFC" was initially capitalized by an exchange of stock from "AIC's" shareholders. Stip. Ex. No. 9, p. 8, lines 8-13. The percentage of "AFC's" dividend income derived from its subsidiaries was approximately: 70% in 1991, 55% in 1992, 77% in 1993, and 61% in 1994. Stip. Ex. No. 23, Condensed Financial Information of Registrant Parent Company Only, ("Dividends from subsidiaries" vs. "Total Income" lines); Stip. Ex. No. 13, p. 64, lines 12-20; Stip. ¶ 94. Moreover, as the Department points out, "AFC" maintained only one central account for deposits of both dividends

from it subsidiaries, and deposits of dividends and capital gain income from stock of unrelated companies. These deposits were the source of funds to purchase additional securities of unrelated companies. Stip. ¶ 121. Thus, dividends from its subsidiaries provided an ongoing source of funds to purchase investments.

Further, the evidence establishes that "AFC" existed to benefit its subsidiaries through loans and capital contributions. Stip. Ex. No. 9, p. 44, lines 22-24; Stip. Ex. No. 13, p. 50, lines 23-25; p. 51, lines 1-5. Within "AFC's" 1991 annual report, under a section entitled Investment Operations, "AFC" states,

> "Investment earnings before taxes reached $193.2 million in 1991, up 15.4 percent compared to 12.2 percent growth in 1990. This year's double-digit growth rate should put the "Aldritch" Companies among the insurance industry's top performers. … During 1992, $92 million in short-term bonds will mature. Plans for 1993 call for increasing this amount to $150 million. This high liquidity means that, as the "Aldritch" Companies gain and use capacity to write more business, obligations to pay claims can be met without disturbing investments selected for long-term potential. …"

Thus, "AFC's" own annual report readily acknowledges that "AFC's" investments are an integral part of its insurance subsidiaries' business. *See*, Stip. Ex. No. 1 p. 14; *See also*, Stip. Ex. Nos. 1-4, "AFC's" consolidated financial statements). The significance of investing to insurance companies, in general, is underscored by the Internal Revenue Code when it defines the gross income of a property and casualty insurance company, for example, as the gross amount earned during the taxable year, from both investment income and underwriting income. *See*, IRC §832-835; s*ee also,* Taxpayer's Initial Brief p. 7. IRC §832(b)(2) provides that investment income is comprised of income from interest, dividends, and rents, while IRC §832(b)(3) provides that underwriting income is equal to gross premiums less losses incurred and expenses incurred.

When questioned, Mr. "Roy Rogers", the Treasurer/Assistant Treasurer of "AIC", "ACC", "AID", and "ALIC" admitted that if "AFC's" subsidiaries needed capital they could request that "AFC" make a convertible debenture offering, thus increasing shareholder value and earnings. This occurred in 1992, when "AFC" distributed the proceeds of a convertible debenture offering to "AIC". "AIC" was then able to provide additional capital to "ACC". Stip. Ex. No. 13, pp. 23-24; and Stip. Ex. No. 59. This additional capital allowed the insurance companies to write more premiums since the Ohio and Illinois Insurance Departments require specific capitalization levels, thereby, increasing the profits of the insurance subsidiaries as well as of "AFC", the parent holding company. Stip. Ex. No. 13, p. 60, lines 6-25.

Finally, "AFC" held itself out as a holding company during the relevant years and existed to primarily benefit its operating subsidiaries. "AFC" held itself out as a holding company within its annual reports during the relevant years wherein it stated:

> "Aldritch" Financial Corporation is a holding company with five subsidiaries, all dedicated to providing independent insurance agents with competitive products, superior service and market stability. The "Aldritch" Insurance Company, The "Aldritch" Casualty Company and The "Aldritch" Indemnity Company offer property and casualty insurance, our main business. Life, health and accident insurance is available from The "Aldritch" Life Insurance Company.

Stip. Ex. Nos. 1-4, p.1.

Amendments to the Insurance Holding Company System Registration Statement were filed with the Insurance Department of Ohio which stated that "AFC's" "[p]rincipal business is that of a holding company." Stip. Ex. No. 54. "AFC" also stated it was a holding company when filing its 10-K statements during each year. Stip. Ex. Nos. 19-22,

p. 2. Interestingly enough, taxpayer admitted that "AFC" was a holding company in its initial protest letter dated September 7, 1995, filed in response to the Department's Notices of Deficiency. Stip. Ex. No. 36, p. 3. It was only later in the administrative hearing process that it changed its position.

Taxpayer argues that "AFC's" own characterization of itself as a holding company on its SEC 10-K statements and annual reports should be ignored since it described itself as a holding company before Section 1501(a)(27) was amended to allow companies which use a one-factor apportionment formula and a holding company to be part of the same unitary business group. It merely continued using this same language in subsequent years. Taxpayer maintains that "AFC" only described itself as a holding company within its own annual reports because it held 100% of both "AIC" and "AFC-I". Taxpayer also argues that "AFC's" characterization of itself as a holding company within its 10-K Statements was irrelevant because it is merely boilerplate language that had been used since 1975. Stip. ¶¶ 112, 113.

Assumedly, "AFC's" accountants and lawyers, who are familiar with its operations, drafted these documents and their language was meant to have some legal effect. One could conversely argue that "AFC's" corporate charter authorizing it to conduct all lawful activities was merely common boilerplate language, yet taxpayer offers this as proof that "AFC" is an operating company. Apparently, it is only before the Illinois Department of Revenue that "AFC" disputes it is a holding company. The taxpayer offers no persuasive reason why I should ignore "AFC's" own characterization of its activities to its shareholders, the public and the SEC during all of the relevant years. Notably, "AFC" described itself as a holding company in both its annual reports and 10-

K statements in spite of the definition set forth in Black's Law Dictionary, thus, tacitly acknowledging that the definition in Black's is not definitive and was not, in fact, contemplated by "AFC".

In sum, "AFC" constitutes a holding company because it was organized to hold the shares of its insurance subsidiaries and its leasing subsidiary and make investments from which the insurance subsidiaries were statutorily prohibited. *See,* Stip. Ex. No. 60. "AFC" activities benefited these insurance subsidiaries by increasing their capitalization thus allowing them to write more premiums and increase profits. Moreover, "AFC" primarily derived its income from its subsidiaries' dividends during the relevant years. The unique characteristics of the insurance industry and its accompanying regulatory schemes impose various restrictions upon the investments of insurance companies. For example, Ohio State regulatory restrictions prohibited the insurance subsidiaries from investing more than 10% of their prior year's assets in equity securities in Ohio. Stip. Ex. No. 60; Taxpayer's Initial Brief p. 4. Similarly, the Illinois Insurance Code imposes numerous capitalization, investment and reporting requirements on insurance companies. *See,* 215 **ILCS** 5/111 and 5/124 *et seq.* "AFC's" activities should not preclude it from being deemed a holding company. Adopting the definition proposed by the taxpayer would allow a company, such as "AFC", which was otherwise unitary with its one-factor subsidiaries, to escape apportionment. As discussed above, "AFC's" investments merely further a purpose for which "AFC" was formed: to benefit the insurance subsidiaries whose stock "AFC" holds. *See*, Jt. Stip. 59, 61; Stip. Ex. No. 13, p. 23-24; Taxpayer's Initial Brief pp. 12-13.

Thus, for the reasons stated above, "AFC" constituted a holding company during the relevant years and may be included in the unitary business group with its insurance subsidiaries.

Alternative Apportionment

The second issue is whether the taxpayer is entitled to alternative apportionment due to gross distortion pursuant to § 304(f) of the Illinois Income Tax Act. The Department's auditor allocated the income of "AFC", excluding dividend income from its subsidiaries, between the two unitary groups 1) the three-factor unitary business group of "AFC" and "AFC-I"; and 2) the one-factor unitary business group of "AFC", "AIC", "ACC", "AID" and "ALIC". This allocation was based upon the percentage of that particular group's gross receipts to the total gross receipts of both groups. *See*, Schedule I-b of Stip. Ex. No. 49 and Stip. Ex. No. 62 (specifically Schedule I-b and I.) The allocation was done for all of the years at issue. *See*, Stip. Ex. No. 62 (auditor's amended schedules and audit reports.) The Department apportioned "AFC's" income to Illinois exclusively on the basis of premiums earned by its insurance subsidiaries in the insurance business they conduct across the United States. Stip. ¶¶ 79, 80; Stip. Ex. Nos. 28-35.

Taxpayer contends that the income producing activities at "AFC's" headquarters in "Someplace", Ohio, that generate "AFC's" income are completely ignored in apportioning "AFC's" income and "AFC's" gross receipts were not included in the numerator or the denominator of the insurance company unitary business group's apportionment formula. Stip. ¶ 81. Taxpayer further argues that the Department's methodology grossly distorts its income apportioned to Illinois.

Section 304(f) provides:

> (f) Alternative allocation. If the allocation and apportionment provisions of subsections (a) through (e) do not fairly represent the extent of a person's business activity in this State, the person may petition for, or the Director may require, in respect of all or any part of the person's business activity, if reasonable:
>
> (1) Separate accounting;
> (2) The exclusion of any one or more factors;
> (3) The inclusion of one or more additional factors which will fairly represent the person's business activities in this State; or
> (4) The employment of any other method to effectuate an equitable allocation and apportionment of the person's business income.

Section 304(f) provides that taxpayers may utilize an alternative apportionment formula, if the statutory formula does not fairly represent the extent of a person's business activity in Illinois. The regulations control that determination. 86 Ill. Admin. Code, Ch. I, Sec. 100.3390 (*formerly* Section 100.3380). Section 100.3390 provides that a fair and accurate alternative method is appropriate if the application of the statutory formula will lead to a "grossly distorted" result in a particular case. The party seeking to use an alternative apportionment method has the burden of showing by clear and cogent evidence that the statutory formula would result in the taxation of extraterritorial values. Lakehead Pipeline Company v. Illinois Department of Revenue, 192 Ill. App. 3d 756, 763, 549 N.E.2d 598, (1st Dist. 1989), *citing* Butler Bros. v. McColgan, 315 U.S. 501, 625, 62 S.Ct. 701 (1942); *see also*, Mobil Oil Corp. v. Com'r of Taxes of Vermont, 100 S.Ct. 1223, 1232, 445 U.S. 425 (1980).

The factors used in the apportionment formula must reflect a reasonable sense of how the taxpayer's income is generated and a rational relationship between the income attributed to Illinois and the intrastate values of the taxpayers' business. An apportionment formula is not invalid because it may result in taxation of some of the

taxpayers' income that did not have its source in Illinois. States are given broad latitude in choosing an appropriate apportionment formula. The Department's apportionment formula may not be perfect, but should be replaced only if it attributes income to Illinois that is out of all proportion to the business the taxpayer transacts in Illinois. Container Corp. v. Franchise Tax Board, 463 U.S. 159 (1983); Moorman Manufacturing Co. v. Blair, 437 U.S. 267 (1978); Hans Rees' Sons, Inc. v. North Carolina ex rel. Maxwell, 283 U.S. 1315 (1931); Underwood Typewriter Co. v. Chamberlain, 254 U.S. 113 (1920); Citizens Utilities Co. Department of Revenue, 111 Ill. 2d 32 (1986); General Telephone Co. v. Johnson, 103 Ill. 2d 363 (1984); Caterpillar Tractor Co. v. Lenckos, 84 Ill. 2d 102 (1981); Miami Corp. v. Department of Revenue, 212 Ill. App. 3d 702 (1st Dist., 1991).

Taxpayer argues that an alternative method of apportionment should be used despite a unitary relationship because apportionment of "AFC's" income based upon its subsidiaries' insurance premiums leads to a grossly distorted result. It argues that gross distortion exists given the 380% increase in its tax liability for 1992 and the 154% increase in 1991. Taxpayer Brief, pp. 28-29. Taxpayer cites Hans Reese & Sons, 284 U.S. 123, 51 S.Ct. 385 (1931) where the court found that gross distortion existed when 388% of the income taxpayer earned in the state was apportioned to the state for tax purposes. Other courts, however, have found that gross distortion did not exist despite greater tax increases than that present here. *See,* Butler Bros. v. McColgan, 315 U.S. 501, 62 S.Ct. 701 (1942) (upholding application of formula apportionment despite 15,000% increase in tax liability from separate accounting method); Citizens Utilities Co, 111 Ill. 2d at 53 ("bare percentages without explanation are not helpful to a determination of the issues at hand"); Miami Corporation, 212 Ill. App. 3d at 708

(increase of $719,000 to more than $2.4 million alone does not necessarily prove malapportionment); Shaklee, Illinois State tax Reporter, ¶400-797 (CCH), (upholding application of formula apportionment where result is income taxable in Illinois when separate accounting produced loss). Thus, an increased percentage of tax liability alone is not determinative.

The taxpayer argues that alternative apportionment is appropriate and relies on Miami Corporation v. Department of Revenue of the State of Illinois, 212 Ill. App. 3d 702 (1st Dist. 1991) to support its position. In Miami, the taxpayer had separated its businesses into two segments. The first segment managed its securities and stock holdings and the second handled its real estate holdings in three states other than Illinois. Taxpayer retained a passive royalty interest in oil and gas reserves in its Louisiana property. It had one employee in Louisiana and 35 in Illinois. The court granted the request to utilize separate accounting since it found the application of the three-factor formula to this unique corporate structure resulted in gross distortion. The gross distortion resulted primarily from the property factor since the historical cost of the 250,000 acres of Louisiana land did not represent the true value of its oil and gas reserves. Id. at 709.

The facts in Miami, however, are dissimilar in that the taxpayer's corporate structure does not possess the unique characteristics of an oil and gas business whose major income-producing element is the value of the oil and gas reserves which were not recognized by the traditional three-factor formula. In the present matter, "AFC" is a holding company that derives its income from the activities of its unitary group of

insurance subsidiaries that did business in Illinois. Thus, taxpayer's reliance on Miami is misplaced.

Taxpayer's proposal to separately account for the insurance companies' income and that of "AFC" (Taxpayer Brief p. 33) would not fairly represent the extent of taxpayer's business activity in Illinois because it fails to account for contributions to income resulting from functional integration, centralized management, and economies of scale. Both the insurance companies operating in Illinois as well as "AFC" benefited from the unitary factors. The unitary relationship between "AFC" and its insurance subsidiaries was illustrated by: inter-company loans, capital contributions, the provision of inter-company services and rent-free office space to "AFC", the sharing of employees, officers, and directors between companies. "AFC's" income producing activities were really those of its insurance subsidiaries, therefore, the apportionment method used by the Department yields a fair result.

Secondly, taxpayer proposes adding a factor consisting of the cost of "AFC's" intangible investments reflected on its books and records, (Taxpayer Brief p. 34). The taxpayer, however, did not present evidence of the specific costs it proposes to use or their relevance. Accordingly, the taxpayer has failed to meet its burden of proving that gross distortion results when the one-factor formula is applied to its unitary business. Moreover, it has failed to prove that its alternative apportionment formulas would more fairly reflect taxpayer's business activities. For these reasons, it is recommended that the taxpayer's request for alternative apportionment under Section 304(f) be denied.

Lastly, taxpayer requested an abatement of Section 1005 penalties due to reasonable cause with respect to the taxpayer's 1991 and 1992 calendar tax years as set

forth on the Notices of Deficiency. The Department did not propose an assessment of penalties against the taxpayer in the Notices of Deficiency issued for the 1993 and 1994 calendar tax years. Stip. Ex. Nos. 32 through 34. While the statute does not define reasonable cause, the Department's regulations state that reasonable cause is to be determined on a case by case basis taking into account all of the facts and circumstances.[4] 86 Admin. Code ch. I, Sec. 700.400(b). Section 700.400 indicates that the most important factor is the extent to which the taxpayer made a good faith effort to determine the correct tax liability and subsection (c) provides that a taxpayer is considered to have made a good faith effort if he uses ordinary business care and prudence. Factors which are considered in determining whether the taxpayer exercised ordinary business care and prudence are the clarity of the law and its interpretation, and the taxpayer's education, experience and knowledge. Id.

Taxpayer argues that the Section 1005 penalties should be abated because the Department did not challenge the taxpayer's classification of "AFC" as an operating company until the audit of its 1991 and 1992 Illinois corporate income tax returns. Clearly, the Department is not estopped from collecting the proper tax by the previous inaction of its agents. *See*, Austin Liquor Mart, Inc. v. Department of Revenue, 51 Ill. 2d 1, 280 N.E.2d 437 (1972). Moreover, the taxpayer has an affirmative duty to determine its proper tax liability and bears the burden of proving that it exercised ordinary business care to justify an abatement of Section 1005 penalties.

[4] The reasonable cause regulation, Sec. 700.400, was not promulgated until the adoption of the UPIA on January 1, 1994, nonetheless, it provides some guidance as to the Department's interpretation of the statutory term "reasonable cause."

Taxpayer maintains that it made a good faith interpretation of IITA Section 1501(a)(27) since its interpretation of "holding company" is consistent with the definition of holding company contained in Black's Law Dictionary. Its argument is undermined, however, since, as previously discussed, taxpayer held itself out as a holding company during the audit period. The taxpayer made sworn statements to governmental entities that "AFC" was a holding company during the audit period. Amendments to the Insurance Holding Company System Registration Statement filed with the Ohio Insurance Department during the audit period affirm the original filing and state that "AFC's" "[p]rincipal business is that of a holding company." *See,* Stip. Ex. No. 54. "AFC" was also identified as a "holding company with five subsidiaries" within its Annual Reports for the relevant years, (*See*, inside cover to Stip. Ex. Nos. 1-4), and the Form 10-Ks filed with the Securities and Exchange Commission state that "the principal purpose of "AFC" is to be a holding company for "AIC" and "AFC-I" and, in addition, for the purpose of acquiring other companies." *See*, Stip. Ex. Nos. 19-22, p. 2. Lastly, "AFC" was identified as a holding company in the initial protest dated September 7, 1995 that was filed in response to the Notices of Deficiency. It was only later in the administrative hearings process that "AFC" changed its position.

It is difficult to conclude that taxpayer made a good faith interpretation of the statute, in light of these inconsistent positions and the clarity of the IL-1120, Schedule UB instructions. Thus, taxpayer has failed to establish that it exercised ordinary business care and acted in good faith in calculating its Illinois income tax liability for the relevant years and the Section 1005 penalties should be finalized.

Wherefore, for the reasons stated above, the NODs should be finalized as revised by the Department auditor's amended audit figures.[5] *See,* Stip. Ex. No. 62.

Date: November 5, 1999

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Christine O'Donoghue
Administrative Law Judge

[5] See Footnote 1.